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Honorable Mayor and Members
of the City Council
City of Madison Heights
300 West Thirteen Mile Road
Madison Heights, Michigan 48071

Dear Mayor and Council Members:

We have recently completed our audit of the financial statements of the City of Madison Heights, Michigan for the year ended June 30, 2003. In addition to the audit report, we offer the following comments for your consideration.

STATE REVENUE SHARING

The City has and will continue to feel the effects of the slowdown in the State's economy. State shared revenue accounts for approximately 15% of the City's total General Fund revenue. Because of slower than anticipated growth in the State's sales tax collections (the sole source of revenue sharing payments to local units of government), and the State's budget problems which have resulted in additional appropriation reductions to the revenue sharing line item in the State's budget, revenue sharing payments for the State's fiscal years ended September 30, 2002 and 2003 were less than originally projected.

Currently, the State's 2003/2004 fiscal year budget includes another reduction to state shared revenue of 3% from fiscal year 2002/2003 levels. This budget includes several very significant assumptions which may not be realized. Additionally, it is generally acknowledged that the State's budget woes will continue for several more years. In fact, as you are no doubt aware, it is anticipated that the Governor may well announce additional reductions in projected state shared revenues as early as this December. We understand that the City's budget for the fiscal year ending June 30, 2004 anticipated the likelihood of reduced revenues to the extent that there is a remaining $75,000 cushion available to help absorb any future reductions from currently anticipated levels. This is a commendable situation to be in. However, we urge the City to continue to be conservative in its estimation of state shared revenue as this line item in the State's budget remains vulnerable.

State shared revenue actually received by the City for the State's 2001 fiscal year was $4,164,651, (which was significantly less than what was originally budgeted by the State), while the City is currently budgeted to receive only $3,460,902 during the State's 2004 fiscal year end. This reduction of $703,749 (if not further modified) represents an overall decrease in the funding of state shared revenue of approximately 17% over a three year period.

We will continue to update the City as developments occur.

STATE TO FUND PERSONAL PROPERTY TAX AUDITS

The State's fiscal year 2003/2004 General Government budget contains an additional appropriation of $7,000,000 to fund personal property tax audits. Given the City's significant industrial tax base, this may well be a program that the City should consider monitoring closely. The Michigan Department of Treasury is responsible for developing the guidelines of the program, and we will be sure to notify you as we become aware of Treasury's progress in this area.

GASB 34 – NEW REPORTING MODEL

We would like to commend the City on its efforts related to implementing the reporting requirements for GASB 34. This pronouncement is by far the most comprehensive reporting change to take effect for governmental entities in recent history. The City's successful implementation required a significant commitment and extra effort by the City's staff, particularly the members of the finance department.

USER FEES

Given the reduction in state shared revenue and other revenue sources, an area that several communities have addressed in an effort to offset at least some portion of other lost revenues is user fees. An analysis of the current level of user fees charged by the City in comparison to other communities, as well as related costs, may prove helpful.

RETIREE HEALTHCARE

In the past, it was common practice for municipalities to pay for retiree health care on a pay-as-you-go basis. With health care costs recently increasing at 15-20 percent annually, many communities are looking at ways to pre-fund this liability, much as they do pension obligations. We understand that the City has proactively begun evaluation of the benefits and implications of pre-funding this obligation. Currently there are three methods that are commonly used by municipalities to accomplish this.

The first method relates to Public Act 149 of 1999. This Act allows communities to set aside monies to fund the retiree health care obligation and to invest these monies in accordance with the Public Employees Retirement Investment Act. To take advantage of this potential for higher returns, the act requires the establishment of a separate fund, with a council resolution which includes the following:

- Designation of the person(s) who shall act as the fund's investment fiduciary
- Restriction of withdrawals from the fund solely for the payment of health care benefits for qualified persons
- Designation of who is a qualified person for purposes of benefit payments
- Determination of whether the fund will be established on an actuarial basis
- Requirement that the obligation will be valued by an actuary at least every five years

RETIREE HEALTHCARE (Continued)

We would be happy to supply you with a sample resolution if you are interested in this funding option.

The second method of pre-funding would be to establish a trust under the Internal Revenue Code 501(c)(9) Trust (VEBA). The third method would be to establish a Section 115 plan. If the City is interested in either of the last two approaches, we would suggest consulting with legal counsel, as the requirements involved can be complex. As always, we would be pleased to assist the City in their evaluation of alternatives.

ACCOUNTING AND PROCEDURES MATTERS

During our testing we noted the following items related to the City's accounting and internal control systems that we believe would benefit from further attention:

- There is no official council resolution documenting wire transfer guidelines and procedures as required by the enabling legislation.

- In conjunction with its ongoing efforts to improve internal controls, the City should have an individual perform an independent review of all bank reconciliations after their preparation to increase the controls related to segregation of duties.

STATE OF THE PENSION FUNDS

As you are no doubt aware, and, as is the case for many communities, both of the City's employee pension plans have had disappointing investment results for the past several years. Lower investment returns have resulted in the actuarial value of the plan assets in both City plans significantly exceeding the actual fair market value of the assets in the plans. At December 31, 2002, the fair market value of the City's general employees plan assets was approximately $4,530,000 less than the actuarial value. Similarly, at June 30, 2002 (the date of the latest actuarial valuation), the fair market value of the Police and Fire Retirement System's assets was approximately $4,860,000 less than the corresponding actuarial value.

These circumstances are the result of actual investment earnings being less than the actuarially assumed rate of return for the past several years. The actuaries are utilizing a smoothing method which recognizes this "underperformance" over a number of years so that the full effect of recent investment performance is only beginning to be apparent in each plan's required contributions.

The implication to future years' contribution requirements, absent other changes in circumstances, is likely to be significant. Even though the option of increased property tax levies is available to fund the police and fire plan's contributions, we urge the City to keep the long term trend of each plan in mind as it undertakes its budget setting deliberations each year.

GEORGE W. KUHN DRAIN PROJECT

While the City periodically receives financial information for the George W. Kuhn Drain Project related to expenditures made against budget and anticipated revenues, we would encourage the City to solicit additional information on a regular basis. Supplemental information, particularly balance sheet reports and details related to the nature and timing of items listed as anticipated revenues, would aid in the City's understanding of the project. This would enable the City to more accurately account for its participation in this project. It would also help ensure that the City is provided its best opportunity to help provide for maximum economies during construction, and to protect its best interests with respect to intergovernmental costing matters.

We would like to thank the City staff again this year for the preparedness, cooperation, and assistance they provided during the audit. If you have any questions, or would like to discuss these items further, please feel free to contact us at your convenience.

Yours truly,

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